

Mgmt 804 – VC Entrepreneurial Management

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Venture Capital Industry

- history – ARD → SBICs → tax & ERISA changes → VCs = experience & expertise
- **VC process** ~ ID deal + structure deal + harvest
- **Entrepreneur's process** – find VCs + choose VC + pitch to VC + close deal
- **VC looks for**
 - **Mgmt** – CEA credentials + caliber of founders + mgmt team completeness + drive of core team
 - **Market** – size, competition, 5 yr revenue potential + revolutionariness of idea (breakthrough qualities) + business v. one-off / nifty product assessment + potential customers
 - **Unfair Advantage** – sustainable competitive advantage + distinct competence of company + workability of business model + timing of market entry
 - **Financial and Legal** – company size in 5 yrs + likelihood of going public in 3 yrs + pricing of this round + BOD seats
- **Key metric** ~ ROI
- **success factors** ~
 - exit – liquidity + IPOs
 - new technologies
- **control mechanisms** – + rigorous screening process + investment timing + form of investment (preferred / convertible) + terms + puts / calls + registration rights + pre-emptive rights / RoFR + anti-dilution + option pools + employment K + vesting schedules / buy back provisions + info rights + BOD representation + budget approval + conversion P + expense re-imbursments
- **VC role** – fills void b/w finance sources for innovation and more traditional / low cost sources of financing
- **looking for** – good managers in hot industries (less interested in good ideas)
- **investors in VCs** ~ institutional investor money mgrs (~T/E)
- **return** ~ carry(% of money managed by VC) + π on own invested funds
- **types of targets** –
 - zombies – π but low fees
 - wild ones – rare (Apple, CPQ, Yahoo)
 - Winners / solids – remain hot after IPO
- **VC emotions** – price + belonging + worthiness + competence
- **Benes of VCs** – experience + expertise + access / open doors + control +

Organizational Issues

- **forms of organization** -
 - **sole proprietorship** – no double taxation + unlimited liability
 - **GP** – no double taxation + unlimited liability + may distribute P& L arbitrarily
 - **LP** – no double taxation + limited liability + may distribute P& L arbitrarily
 - **C Corp** – taxable + limited liability
 - **S Corp** – no double taxation + limited liability + strict qualifications (only one class of stock / no more than 25% of rev from passive sources / only individuals, estates, trusts as SH / election requires unanimous & timely consent of all SH)

- LLC – no double taxation + limited liability + may distribute P& L arbitrarily + governed by state law
- **key factors in determining form** – who are investors + what are capital requirements + what will CF be like + what is time frame for life of business

Intellectual Property Protection

- **Patents** –
 - essentials – a negative right to exclude others + has own patent court system
 - **utility patent** – **20 yrs**
 - **requires** - must meet specific requirements ...
 - **i)** subject matter categories ~ machine / manufacture / composition of matter / processes
 - **ii)** actual, original inventor must apply (may be assigned to a corp)
 - **iii)** invention m/b new / novel → not known or used by others in US + not patented / described by others in printed publication in US or foreign country + not made in US by another who had not abandoned, suppressed, concealed it
 - **iv)** m/b useful (even if only minimal)
 - **v)** must be non-obvious
 - **vi)** application m/b timely filed (~ w/i one yr of being sold, described in print, attempted to secure foreign patent)
 - **design patent** – **14 yrs**
 - **requires** - must meet specific requirements ...
 - **i)** ornamentality – design m/b aesthetically appealing AND must not be dictated solely by functional / utilitarian considerations
 - **ii)** novelty – design m/b new (cf utility patent above for same requirements)
 - **iii)** non-obvious – design m/b not obvious to anyone skilled in the art → subjective and hard to meet
 - **iv)** embodied in an article of mfr – design m/b an inseparable part of a manufactured article
 - **plant patents** – **20 yrs**
 - **requires** – any new variety of plant which an individual can reproduce asexually
 - **i)** new variety of plant
 - **ii)** individual can get plant to reproduce asexually
 - **iii)** plant m/b non obvious
- **Copyrights** – **life + 50 yrs**
 - available to – artist, author
 - right afforded – sole right to print, copy, sell, and distribute work
 - copyrightable subject matter – books, musicals, dramatic compositions, maps, paintings, sculptures, motion pics, sound recordings
 - how obtained – work simply bears **i)** copyright notice (c) or word “copyright” + **ii)** date of first publication + **iii)** copyright owner’s name
- **Marks** -
 - types -
 - **trademark** – any name, symbol, configurations which individual / organization uses to distinguish it products
 - legal authority – outgrowth of common law (not Constitution)
 - **coined marks** – newly coined, previously unknown mark (~ any “brand” ~ Xerox) → broadest protection
 - **arbitrary marks** – name already in use, but applied to certain product w/o suggesting any of products attributes (~ Apple)
 - **suggestive marks** – name in use, but suggesting some desirable attribute of product (~ Sweet-n-Low)
 - **descriptive marks** – name which describes purpose / function of product
 - cannot be registered until prove to be distinctive over time
 - **trade dress** – look and feel of a retail establishment → has been successfully defended
 - **unprotectable terms** – generic names that refer to general class of product
 - requires – continual use and protection + use TM or SM marks after name
 - key goal – protect originator from an imitator copying / unfairly trading on value created by originator
- **Trade Secrets** –
 - includes – formula, device, process , info giving business advantage over competitors

- cannot be patented (due to secrecy)
- key bene – no time limit
- con – if someone else discovers + patents → force originator to pay royalties
- **Confidential Agreements** – arise as matter of K (→ upheld by K)
 - e.g., customer lists
- **Employee Rights** – balancing the rights of business
 - **reasonableness test** – time horizon + geographic scope + nature of employment

Management Compensation

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Valuation

- **VC Method** -
 - process –
 - i) project firm's future N/I
 - ii) apply comparable P/E to find future value
 - iii) discount future value to today at target RoR
 - iv) find **required final ownership %** = **proposed investment / NPV of future value**
 - v) find **required current ownership %** = **required final ownership % / retention ratio**
 - **retention ratio** ~ $1 / (1 + \text{future}_1 \text{ dilution \%}) \dots / \dots (1 + \text{future}_t \text{ dilution \%})$
 - vi) number new shares to be issued = $\left[\frac{\text{current shs O/S}}{(1 - \text{required current ownership \%})} \right] - \text{current shs O/S}$
 - vii) price per new share issued = **current investment / new shares issued**
 - viii) implied **pre money** valuation = **current shs O/S * price per new sh issued**
 - ix) implied **post-money** valuation = **total post money shs outstanding * price per new sh issued**
 - cons – comps + mood of public markets + application of new metrics +
 - VC's justification for method – large discount rates justify illiquidity, compensate VC for services, equalize Entrep. optimistic forecasts
 - Economists rebut – premium is too large → lots of LT investors exist to mitigate the illiquidity issue + services s/b valued re market Ps for professional services + CF s/b adjusted to account for optimistic estimates (not discount rate)
- **Comparables** -
 - cons – finding comps + unavailability of key accy info for private cos + trends may have whole industry mis-priced + finding relevant metric (EBIT ignores capital structure) + possible need for discount for illiquidity
- **NPV** –
 - process –
 - $WACC (r) = [(D/V) * r_d * (1-t)] + (E/V) * r_e$ [use target capital structure]
 - $r_e = r_f + B(r_m - r_f)$
 - $B_U = B_L * (E/V) = B_L * [E / (E+D)]$
 - Betas ~ from comp public cos
 - **earnings Betas** ~ companies' net income relative to stock market index (~if no other Beta)
 - discount CF (including investment) to today

- calculate TV (use Gordon Growth model)
 - discount TV to today
- cons – lack of Betas + use of comps to find target capital structure + too much value in TV + research shows that Beta may not be best measure of firm risk (better ~ firm size, Book / Market equity, et al) + difficult to apply if capital structure / effective tax rates change over time
- **Monte Carlo simulation** – use to model all possible combos of inputs
- **APV** -
 - process – find CF + discount CF at r_E (w/ B_U) + calc tax benes + discount tax benes at r_D + value NOLs + discount NOLs at r_D
 - bene – works better than NPV if firm capital structure changes or has NOL to offset future taxes
- **Options Analysis** –
 - process -
 - Exercise P ~ PV of expenditures to undertake project
 - S ~ PV of expected CF from project
 - t ~ length of time investment decision c/b deferred
 - σ - riskiness of underlying assets → look at Stock P volatility for comp cos (BUT adjust for leverage)
 - r_f – risk free rate
 - bene – accounts for value where firm has flexibility (e.g., ability to abandon project, follow-on investments, etc.)
 - cons – unknown to business people + difficult to frame real world opps in option terms + limitations of B/S
- **Pricing process** – start with necessary return at IPO and work backwards, accounting for any dilution and added funding
- **Raising Capital** -
 - process -
 - set funding objectives – time horizon, maximum dilution, minimum capital this round
 - prepare plan to attract investors
 - choose capital raising strategy – bring current investors on board
 - assign tasks – motivate the team
 - launch campaign – focus on people familiar with industry / product / service
 - present –
 - focus on – the opportunity, CF, ROI in short time
 - leave out – pricing, proprietary info
 - avoid – experts b/c hired to not be wrong
 - get feedback from presentation (listen to advice given by VCs)
 - modify business plan (retain vision)
 - due diligence – once VCs express interest
 - lead VC says yes
 - move toward closing the K – convert verbal commitment to legal obligation
 - closing week – atty's sign
 - cash in bank – get ready for next round
 - key participants – start-up consultant + atty + accy + VC
 - phases – 1st round + multiple rounds + mezzanine (last round before IPO) + IPO
- **remember** -
 - mgmt should seek to foster competitive bidding

Fundraising

- **cost of financing** -
 - lose discipline of self financing
 - risk raising too much
 - lose flexibility – investors may be less patient w/ hit and miss approach to problem solving
 - focus on business replaced by focus on \$\$
- **Bootstrapping keys** –

- get operational quickly
- find quick break even / cash generating projects
- offer high value products / services that sustain direct personal selling – b/c is difficult to overcome customer inertia
- avoid hiring professional mgmt team – you won't have the \$\$ for this → many in unemployment market have skills you can use
- keep growth in check – many start-ups fail b/c they cannot fund their growth (be wary of customers who will put the company under, don't pay bills, shop only on P)
- focus on cash – this is key metric when short on funds (π, market share, etc. are relevant if have sufficient CF)
- cultivate bank relationships before become credit worthy – this requires preparation and want in place when needed
- plan for operational changes that might be necessary to continue growing
 - exit niche & compete w/ big cos
 - offer standardized / less customized products
 - bring critical services in house
 - change mgmt focus from CF to strategic growth
 - recruit higher P talent
- **Writing business plan** –
 - Key factors critical to any venture -
 - **people** –
 - most important factor; w/o right team, nothing else works; key value is execution skills
 - look for – reputation + past accomplishments + relevant experience + education + skills, abilities, knowledge + realistic grasp of opportunity and obstacles + who missing + drive + what are motivations
 - **opportunity** –
 - generally - market growth + returns + customers + “pull” of product / service by customers + pricing + any unrecognized customer segments + cost to acquire customer + cost to produce / deliver product + cost of supporting customer + ease of customer retention
 - CF issues – typical customer / supplier float + amt of equipment to support \$ of sales
 - competition issues – who is it currently + what resources do they control + strengths / weaknesses + new venture's ability to respond to their responses + ease of entry (any BtE) + opps to co-op potential partners
 - **context** –
 - identify / explain how following help / hinder venture - macroeconomic environment + gov't rules & regs + technology +
 - describe how mgmt can react when context turns negative
 - explain how mgmt can affect the environment
 - **risk / reward** –
 - identify risks (necessary to have any credibility w/ investors)
 - simplify business model as much as possible (~ safest thing is a PO box to which people send \$\$)
 - identify “harvestability” – describe exit options (IPO / trade sale / etc.) = how easy is this + when will it occur + what are obstacles to this happening + what ability does mgmt have to make this more likely
 - consider who plan to raise money from – this will impact mgmt's future flexibility
 - Risk – is inevitable → risk management is key
- **Choosing VC** – consider ...
 - prepare well → is difficult to get idea reconsidered once rejected
 - choose wisely → if many VC's reject → plan gets “overshopped” reputation
 - identify key VC attributes –
 - amt of capital managed – consider VC's max / min for investments made
 - geographic pref – key in lining up the lead investor
 - industry pref – match specialization with concept to facilitate VC's understanding + relevance of expertise / contacts
 - stage of development pref (start-up / growth / maturity / decline-turn around) – these will vary b/w firms
 - investment leadership role – some firms like to lead while others are more passive
 - get quality introduction to meet w/ VC

- **Meeting VC** – consider ...
 - initial goal ~ convince VC that idea merits further investigation
 - focus on – what is unique about the idea
 - demonstrate overall business acumen – VC will be implicitly looking at this to determine credibility
 - maintain momentum – if VC interested → follow up (they are busy people, be persistent, not rude)

- **Other Sources**
 - Angels -
 - typical investment – 5k to \$\$M
 - who are they – rich retired professionals, entrepreneurs, etc.
 - how found – where rich retired professionals hang out
 - Corporate Investors -
 - Government sponsored financing -
 - State programs -
 - Aggressive bank financing - includes - SBA guaranteed loans + lenders willing to stretch lending criteria

- **Down round financing issues** -
 - legal issues – especially if insider participates in down round
 - BOD steps to protect self – compelling BOD record + diligent assessment of alternatives + fairness opinions + approval by independent Dir + disinterested S/H approval + full disclosure of terms + rights offering that allows all to participate

Term Sheet

- liquidation prefs – may disincentivize mgmt performance

Corporate Governance

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